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September 11, 2014

Hon. Monica Lindeen  
Commissioner of Securities and Insurance  
840 Helena Avenue  
Helena, Montana 59601

Dear Commissioner Lindeen:

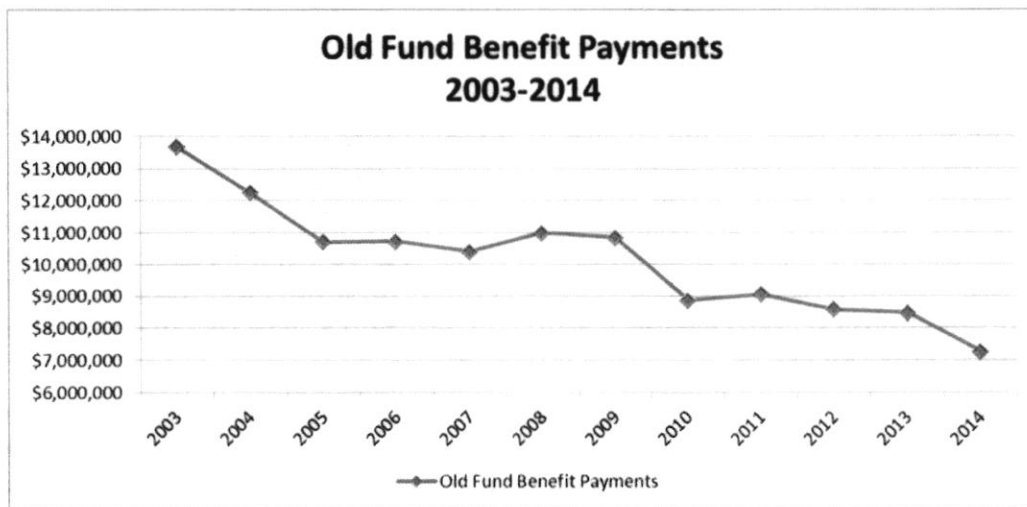
Montana State Fund (MSF) wishes to express our thanks to the Commissioner of Securities and Insurance (CSI) and to Financial Risk Analysts (FRA) for their review of MSF loss reserves as of June 30, 2013 and rates effective for the period July 1, 2014 through June 30, 2015. We also appreciate the opportunity to provide MSF's perspective to the findings and recommendations contained in the report. Our overall response to the findings and recommendations are contained in the following paragraphs. We have included the more technical response and comments from the MSF independent consulting actuary, Towers Watson (TW), since the FRA report is a review of the work performed by TW.

MSF is pleased and agrees with FRA's findings that MSF reserves are reasonable and rates are neither inadequate, excessive, nor unfairly discriminatory. FRA's findings provide additional assurance that MSF is likely to have adequate funding to meet its financial obligations to injured Montana employees for claims incurred on or after July 1, 1990. Montana State Fund works diligently to ensure that our financial obligations to injured Montana employees will be met and that Montana employers have reliable access to fairly priced workers' compensation insurance in a stable rate environment.

The following summarizes MSF's response to the specific FRA recommendations as found on pages 36-38 of their report:

- We concur that MSF should continue to carefully consider the elevated level of uncertainty in estimating reserve liabilities. MSF books its "New Fund" reserves in the upper range of our consulting actuary's central estimate to insure that MSF is more likely than not to have the strength to meet its financial obligations. We have confidence in our consulting actuary's central estimate as a reasonable estimate of the point at which the risks of being over reserved or under reserved are balanced. The fact that Towers Watson's central estimate is below the simple average of all indications merely reflects appropriate judgment regarding the weight given to the various actuarial methods.

- We concur with FRA that “Old Fund” liabilities are more likely to fall within the upper end of TW’s range. We appreciate FRA’s findings as to the risk that Old Fund (OF) liabilities may exceed Towers Watson’s (TW) central estimate. The estimates of OF liabilities that will be paid out over the next several decades are subject to a very high degree of uncertainty as is generally noted by FRA in their report as well as documented by TW in their analysis. The unknowns at play include anticipating life expectancies and what kinds of medical conditions will arise and be treated in the meantime, uncertainties that are particularly pronounced for the OF given the statutory benefit structure and operational environment in effect when these claims arose. The annual benefit outlays for the OF will likely continue to diminish over time. The graph below shows the history of declining annual claims payments over time as claims are closed in the OF. Over the past twelve fiscal years, annual benefit payments have declined from \$13.7 million in FY 2003 to \$7.2 million in FY 2014.



The actuarial uncertainty and differences in the actuarial estimates is over how fast benefit payments will taper off before the last dollar on the last claim is finally paid. Insofar as OF liabilities are being paid on a pay as we go basis by the state General Fund, the actuarial estimates are informative regarding the range of likely ultimate liabilities. That said, they are merely estimates that will be adjusted from year to year, but we have certainty the amount needed to pay the outstanding claims will continue to decline over time.

- MSF is not opposed to conducting another claim study to evaluate MSF case reserve practices and we will again present the option and discussion to the MSF Board of Directors. Our concern with the recommendation relates to the cost-benefit of such a project insofar as no claim study would ever be definitive with respect to determining whether current case reserves are adequate, redundant or inadequate to quantify a level of case reserve redundancy. Previous claim studies of MSF claim management processes have found nothing about MSF reserve practices to be inappropriate. Another claim study is unlikely to materially reduce the level of uncertainty nor significantly add to our current understanding of case reserve adequacies. A similar recommendation was included in previous reviews completed by FRA dated May 18, 2012 and October 2,

2013. Our response the recommendation contained in those reports is also appropriate as comment to the recommendation contained in this current report as follows and we would also add that the negative IBNR occurs predominantly in the years before the current structure of MSF where MSF has been able to address adequate staffing for more effective claim management:

*"We are aware of the difference between individual case reserves and actuarial reserves on older accident years, (generally accident years 12 years in maturity and older, including the Old Fund). We also understand the nature and source of the differentials. FRA identified what is known as negative IBNR (Incurred but not reported). Negative IBNR is atypical but not unheard of in the workers compensation line. According to National Council on Compensation Insurance (NCCI) data, Montana has an unusually long medical tail relative to other states. MSF has a relatively high number of claims from the late 1980s and early 1990s where the negative IBNR is most prominent. MSF had its highest market share during these years. Therefore, the long medical tail in Montana disproportionately affects MSF case reserves and manifests as negative IBNR.*

*Claim examiners establish their estimates for individual claims, given the known facts of each case. The case reserve enables the claim examiner to anticipate and manage likely claim outcomes. Much of the difference between case and actuarial reserves involves lifetime medical benefits. In nearly all instances, the claim examiner assumes a life expectancy applicable to the general population because treating physicians are reluctant or unable to opine to a different life expectancy. The case reserve also attempts to reasonably anticipate end of life medical treatments. However, the actuarial analysis suggests that, in the aggregate, mortality rates will likely exceed what is being assumed on an individual claim basis and that not all potential end of life medical costs will materialize or will not materialize as a workers' compensation liability. Case reserves are primarily a claim management tool. While case reserves are an important data component in actuarial estimates, they should not necessarily substitute for sound actuarial judgment."*

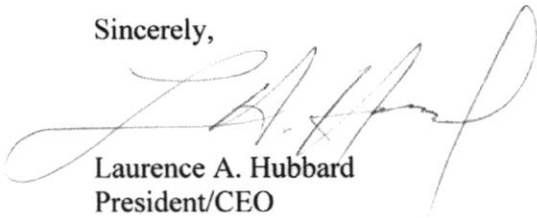
- MSF would not object to an audit of OF claims handling practices if the state believes such an audit would be cost beneficial. We note that the Legislative Audit Division has the authority to conduct performance audits on any aspect of MSF operations, including the OF. If an audit is conducted, we recommend that the audit be performed by claim professionals who are familiar with the specific workers compensation laws of Montana in effect when OF claims were incurred and that the audit be conducted in a manner which protects the confidentiality of individual claimants. We have no opinion on whether the state should expand its oversight role of OF claims handling but stand ready to cooperate should the state wish to receive more reporting. We recommend that the state carefully consider any relevant claimant confidentiality requirements in exercising such an oversight role.
- MSF concurs that a contingency provision for adverse loss deviation is a prudent and appropriate practice given MSF's role as guaranteed market and our ability to return

excess equity to our policyholders through our dividend program. We concur that this practice helps to stabilize rates despite an environment of elevated uncertainty.

- MSF partially concurs with FRA's recommendation to give weight to incurred loss indications. It is important to note that TW is using standard incurred loss development methods in selecting their indemnity loss reserves. TW is not using standard incurred loss development methods to select their medical loss reserves because of the historical instability in the medical loss reserves. We are encouraged to see tentative evidence that medical incurred loss development patterns are stabilizing but we defer to the professional judgment of our independent consulting actuary as to whether and when medical incurred loss patterns are sufficiently stable to be reliable as a basis for actuarial selections.

The report of FRA will be provided to the MSF Board of Directors and the recommendations discussed with them. As always, MSF is prepared to discuss these or any other issues to provide additional information to assist in providing greater understanding of MSF procedures and practices.

Sincerely,

A handwritten signature in dark ink, appearing to read 'L. A. Hubbard', is written over the typed name and title.

Laurence A. Hubbard  
President/CEO

cc: Financial Risk Analysts  
Russell Greig, Towers Watson